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How Far Might the Price of Oil Fall?

(if fighting subsides in the Gulf, and, especially if peace breaks out)

I seem to write a version of this memo every six months or so, but once again, circumstances seem to warrant it.

The IEEW of 16 July 1982 shows that the demand for OPEC oil between the 2nd and the 4th Quarters of 1982 is likely to increase by 2-4 million barrels per day. (My guess is that the lower end of this range is more likely than the upper.) Several OPEC producers have given indications that they intend to increase production substantially over their 2nd quarter rate, Venezuela, Nigeria, Libya, and Iran among them. These countries seem to intend to increase oil production by 1-1.5 million b/d. If they do, Saudi Arabia and Kuwait will be able to increase their oil output by 0.5-3.0 million b/d (again, most likely the lower end of this range). As the IEEW points out, downward pressure is likely to be sustained on the price of oil.

Beyond 1982, this downward pressure could intensify greatly. Ending of the war between Iran and Iraq could bring on to the market an additional 2-3 million b/d. Moreover, Mexico seems likely to expand production by about 1 million b/d over the next three years. Other non-OPEC supplies will also grow slowly. Meanwhile, demand growth will remain sluggish.

By mid or late 1983, the demand for OPEC oil could be about 10 million b/d less than its effective production capacity (up from an excess capacity of around 7-8 million b/d today). And some of the "new"

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capacity would be in countries highly motivated to produce: especially Iraq and Iran. In this situation, the price of oil could collapse. How far it might go down is strictly a guess in view of the fact that the incremental costs of producing oil from existing facilities are a small fraction of today's market price. My guess is that it could fall to \$15 a barrel or less for a period of some months or maybe a year or so. After that it would probably climb back to a somewhat higher level as demand slowly picked up and as the effects of reduced exploration and development began to be felt.

Such a collapse could be avoided if the major oil exporter could make a pro-rationing system work. They might be able to do so but recent evidence isn't encouraging from their standpoint. It might require the shock of \$15 a barrel oil to get the producers to accept cartel discipline (and even that might not do the trick). Another possibility is that Saudi Arabia might try to lower the OPEC price to, say, \$30 or \$28 per barrel and try to hold it there, but if it tried, it might not be possible for it to stop short of a precipitous decline.

Of course, if Iran whips Iraq and there are larger political and military repercussions in the Arab world none of this is likely to happen.

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